GLOBAL CAPITAL AND NATIONAL INSTITUTIONS

Crisis and Choice in the International Financial Architecture

Laura Alfaro

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Contents

Introduction

All managers face a business environment in which international and macroeconomic phenomena matter. Understanding these phenomena — the determinants of capital flows, the effects of foreign capital on host countries, the impact of exchange-rate movements, and the genesis of financial and currency crises — is a crucial aspect in making informed managerial decisions. International capital flows can significantly affect countries' development efforts and provide clear investment opportunities for businesses. Adverse macroeconomic phenomena can exert a catastrophic impact on a firm's performance, as evidenced by the many strong companies destroyed by the successive crises in Latin America, the Asian financial crisis, the recent U.S. subprime mortgage crisis and the global financial meltdown of 2008 and 2009. But such episodes can also create business opportunities, and not just for the speculators that profit from them. Managers who have and use a coherent framework for analyzing these phenomena can secure a competitive advantage.

This book presents a series of case studies taught in the Harvard Business School course *Institutions, Macroeconomics, and the Global Economy* (IMaGE). The course addresses the opportunities created by the emergence of a global economy and proposes strategies for managing the risks associated with globalization. The course emphasizes both the economic consequences of policies and the political and institutional context in which they are established and implemented. The material thus bridges a gap between firm- and household-level behavior, which is typically well understood by a managerial audience, and aggregate phenomena, which are often less understood by this audience.

The cases in this book have been designed to give students an appreciation of the critical role of institutions and policies in affecting patterns of international capital flows and the abilities of government to manage them effectively. The case studies in the module are tied together by two broad themes: (1) the determinants and effects of international capital, and (2) policy-makers' management of these flows. The cases approach these themes by exploring institutional detail in deep local context. Students are exposed to key recent events that have shaped the way economists think about these subjects. The events covered have a clear global perspective as the cases are set in Africa, Asia, Europe and Latin America, as well as the U.S. The cases also cover events that occurred during the last three decades as not only do they affect the business environment that managers face today but they also hold important lessons. An important feature the cases reveal is the cyclical nature of international capital flows.

The cases in the book were written to encourage students to consider several fundamental characteristics of the international financial system: Why cycles in international capital flows recur; and how does sovereign debt and domestic debt differ from each other in their contracts, explicit and implicit, and their enforcement. The module also teaches students three key insights from the field of international economics. First, trade in goods is different from trade in financial assets: A financial transaction inherently involves a commitment to pay at a later date. Financial transactions are therefore fundamentally affected by problems of asymmetric information and the risk that the contract will not be enforced, and both problems are exacerbated at the international level. Second, international financial flows are affected by two additional macroeconomic risks that are absent within countries: sovereign risk and the use of different currencies. Third, international capital flows imply additional policy challenges for countries as policy makers face a difficult trade-off among three objectives: monetary policy autonomy, a stable fixed exchange rate, and free capital mobility. Research has demonstrated that local conditions — political objectives, financial markets, firms, and institutions — decisively influence the operation of these basic macroeconomic logics in actual practice. As a whole, the module emphasizes the importance of domestic institutions for effective macroeconomic policy-making, capacious regulations, credible policy commitment, and attracting and using foreign direct investment efficiently.

During the 1990s and early 2000s, the world witnessed an explosion in capital flows at the global level. Gross foreign assets and liabilities stood at two or three times GDP for many countries, as compared to just two decades ago. This explosive growth, especially in emerging markets, has been fueled both by changes in world politics (e.g., the end of the Cold War, collapse of the Soviet Union, shifting political climate in China, and political changes in Latin America and Asia) and advances in technology. Private capital flows — debt finance, equity capital, and foreign direct investment (FDI) — became larger than current and past official capital flows. FDI has become the dominant source of foreign private capital for emerging markets, promising additional productivity gains for recipient countries. Beyond merely adding to the stock of capital, FDI may translate into the promise of better technology, modern management, and greater access to global markets. Portfolio equity liberalization might help in a different way by exposing local companies to the scrutiny of the international capital market (and potentially requiring greater accounting transparency and more effective corporate governance). This new era of foreign capital mobility has also been characterized by low interest rates in industrial countries, growing external imbalances in the U.S. economy, and the rise of China, all of which posed new challenges to policy management.

In 2009, the global economy remained mired in a deep crisis following the subprime meltdown in the U.S. The World Bank, in one of its bleakest assessments yet of the ongoing crisis, estimated that the global economy would contract in 2009 for the first time since World War II. The World Bank's sister organization, the International Monetary Fund (IMF) released a similar outlook. More than US$50 trillion in wealth had been wiped out across borders over the last 18 months. Policy makers across the world found themselves trying to tackle a dizzying array of problems, from rising unemployment to frightened investors to plunging exports. According to one view, shared by many academics and policy makers, the financial sector debacle had its origins in the "global imbalance" — the phenomenon of large current account surpluses in China and a few other countries co-existing with large U.S. deficits. The situation was also a true testimony of how intertwined individual economies had become over the years. With the explosion of international capital flows, financial institutions in various corners of the world had inadvertently participated in the U.S.' debt-financing boom. The effect of policies to deal with the ongoing global crisis and new policy choices remained to be seen.

This book is composed of three intellectual segments: I. *Determinants and Effects of International Capital Flows*; II. *Policies and Strategies for Harnessing the Benefits of Financial Globalization*; III. *Challenges and Policies of Large Economies.* Section I explains the purpose and provides the basic insights of the module. Section II presents a detailed overview of the cases and readings in the module. The last section relates the cases in the module to the main patterns of international capital flows in the last 30 years. It also presents the key insights from the field of international economics covered in the cases as well as the current state of debate among policy makers.

I. PURPOSE AND BASIC INSIGHTS OF THE MODULE

This book focuses on the costs and benefits of international capital and the policies utilized to make it work. It is composed of three intellectual segments.

- The cases in *Determinants and Effects of International Capital Flows* study both potential positive and negative effects in host economies of opening up to international capital flows. In particular the cases analyze the effects of capital flows in the development efforts of countries, with an emphasis on FDI (which has become the main source of private flows to emerging markets) and the policies to attract and maximize FDI's benefits. In addition, the cases in this first segment analyze the effects of international capital flows in the context of financial crisis.
- The second segment of the book, *Policies and Strategies for Harnessing the Benefits of Financial Globalization*, focuses on the strategies to harness the benefits of financial globalization and minimize potential risks. The cases cover policies regarding the management of capital inflows using capital controls, the choice of exchange rate regime, and policies associated with the management of sovereign defaults. The module ends with a discussion of the effects of transfers of capital and debt relief between rich and poor countries.

- The last segment of the book, *Challenges and Policies of Large Economies*, studies the cases of the three largest economies in the world (Japan, China and the U.S.).[1] Because of their economic importance and political power, the policy options available to these countries, and their effects, are in many ways different from the standard "small open economy" cases analyzed previously in the module. The module ends with a discussion of the "global imbalances", the U.S. subpime crisis and the global financial crisis of 2008–2009.

Technical notes on capital controls, foreign direct investment, and sovereign debt and the international financial architecture accompany the cases.

II. OVERVIEW OF CASES AND READINGS

"Botswana: A Diamond in the Rough" (HBS No. 703-027)

Case Synopsis

Since achieving independence in 1966, Botswana has recorded the highest sustained real GDP growth rate in the world. Moreover, Botswana, arguably the most politically stable country in Africa, has enjoyed a democratic regime since independence. The achievements of this small, landlocked country situated in sub-Saharan Africa, appear even more impressive because they have occurred in a region generally associated with economic stagnation and political unrest. The case highlights Botswana's mutually profitable partnership with De Beers as evidence of using FDI as a successful development strategy. Independence leaders such as Sereste Khama and Ketumil Masire gained a broad political base and made far-sighted policy decisions about the country's most important asset, diamonds. The fact that Botswana was able to avoid the natural resource curse that has haunted virtually all natural resource-abundant countries, including Angola, Zaire (Congo), and Nigeria, is largely attributable to the role played by the institutions. But going forward, a weaker diamond market and no strong alternative sector for foreign investment pose major challenges for the nation.

The note "Foreign Direct Investment" (HBS No. 703-018), which provides an overview of the evolution of international business and analysis of cycles of world opinion regarding FDI, is a useful complement to the case.

Teaching Objectives

- Define and differentiate FDI flows from other forms of foreign capital flows.
- Discuss the determinants of and motivations for FDI flows.
- Analyze the benefits of FDI and FDI-led strategies to host countries.

[1] The case book "Institutions Macroeconomics and the Global Economy," by Rafael Di Tella, Huw Pill and Ingrid Vogel (World Scientific, 2005) analyzes in detail the European Union experience.

- Analyze the origins of Botswana's institutions and the role of leadership in the country's development.

Proposed Assignment Questions

1. Is Botswana a success story?
2. What accounts for the country's performance?
3. Is this performance sustainable?

Supplementary Reading List

- Alfaro, L., S. Kalemli-Ozcan and V. Volosovych (2008). "Why doesn't capital flow from rich to poor countries? An empirical investigation," *Review of Economics and Statistics*, 90, 347–368.
- Acemoglu, D., S. Johnson and J. Robinson (2003). "An African Success Story: Botswana." In *In Search of Prosperity: Analytic Narratives on Economic Growth*, D. Rodrik (ed.), Princeton: Princeton University Press.

"Foreign Direct Investment and Ireland's Tiger Economy" (HBS No. 706-007)

Case Synopsis

Ireland's transformation from one of Europe's poorest countries into one of its richest in a short span earned it the nickname "Celtic Tiger." Its spectacular growth is attributed in large part to FDI, particularly from the U.S. Ireland has, through government institutions such as the Irish Development Authority (IDA), focused its energies on attracting foreign investors with a combination of marketing strategies and fiscal and financial incentives. But the remarkable economic record of the 1990s, notwithstanding the efficacy and long-run viability of an FDI-focused growth policy, has come under scrutiny. Can Ireland continue to attract and sustain significant levels of FDI in the face of rising costs and labor shortages at home and increasing competition from eastern European countries, aggressively trying to attract foreign investment and reducing corporate taxes?

The note "Foreign Direct Investment" (HBS No. 703-018), which provides an overview of the evolution of international business and analysis of cycles of world opinion of FDI, is a useful complement to the case.

Teaching Objectives

- Critically assess Ireland's development strategy.
- Discuss and debate the role of FDI, pros and cons as well as benefits and costs, in the context of Ireland's growth.
- Critically assess the merits of government policies for attracting FDI to a host country.

- Discuss the effects of policies for attracting FDI within the context of the European Union.

Proposed Assignment Questions

1. What accounts for Ireland's economic success? What role did FDI play?
2. Should countries subsidize FDI? What are the pros and cons of FDI?
3. Are there lessons for other countries? Can the Irish model be replicated?

Supplemental Reading List

- Alfaro, L., A. Chanda, S. Okalemli-Ozcan and S. Sayek (2004). "FDI and economic growth: The role of local financial markets," *Journal of International Economics*, 64, 113–134.
- Navaretti, G. B. and A. Venables (2004). *Multinational Firms in the World Economy*, Princeton: Princeton University Press.

"Transforming Korea Inc.: Financial Crisis and Institutional Reform" (HBS No. 708-007)

Case Synopsis

In December 1997, Korea, which had prided itself on its remarkable growth over the previous few decades, suffered the humiliation of asking IMF for a record US$58 billion bailout. Korea had emerged from the aftermath of the Korean War (1950–1953) and embarked on an export-led growth strategy that, by the 1980s, had transformed the nation from one of the lowest-income countries in Asia into a major exporter. The country's economy continued to grow at a rapid pace through aggressive state intervention and capital controls, coupled with high savings and relatively low unemployment. By 1996, Korea had become the world's 11th largest economy and joined the Organization for Economic Cooperation and Development (OECD). But just one year later, it was swept up in the Asian financial crisis, which exposed fundamental weaknesses in its economy, ranging from huge bad loans in the banking sector to overcapacity in the manufacturing sector to reckless growth policies pursued by large conglomerates — the engines that had been driving the nation's economic growth. Under the IMF's guidance, Korea launched a sweeping reform plan that overhauled its financial sector, revised its domestic labor laws, and opened up its market to greater foreign investment.

As Korea approached the ten-year anniversary of the financial crisis, reactions were mixed. Some observers praised the country for having made significant improvements in its banking system and overall regulatory environment. But others believed that Korea needed, in addition to regulatory and institutional reforms, to find a new growth model capable of generating sustainable economic growth, especially as neighboring China and Japan seemed to be increasingly threatening its competitiveness in the global export market.

Teaching Objectives

- Explain the role of economic development strategy in the context of a country's political background, recognizing that political constraints, especially if international or domestic political conditions change, might facilitate or hinder growth strategy.
- Understand the benefits of capital mobility versus the potential risks of financial liberalization in the case of Korea, in particular, in relation to the large family conglomerates that dominated the country's economic landscape for decades.
- Grasp the origins of Korea's financial crisis such as vulnerabilities to external shocks and institutional inadequacies, both domestic and global.
- Explore and examine the appropriateness of the policies that the IMF prescribed to a country suffering from financial crisis.

Proposed Assignment Questions

1. How did Korea achieve its economic "miracle"?
2. If Park's strategy up to 1979 was so successful, why did his successors want to change it?
3. Was the financial crisis of 1997 inevitable? What were the main causes of the crisis?
4. Were the IMF's policies appropriate for Korea at that time? Why or why not?
5. How did Korea change through the crisis?

Supplementary Reading List

- Stiglitz, J. (2002). *Globalization and Its Discontents.* New York: W.W. Norton & Company.
- Rogoff, K. (2002). "An open letter to Joseph Stiglitz." Washington DC, http://www.imf.org/external/np/vc/2002/070202.htm, accessed October 2007.
- Joon-Ho, H. and F. Mishkin (2000). "Causes of the Korean financial crisis: Lessons for policy," NBER Working Paper No. W7483, http://ssrn.com/abstract=211229.
- "Gold from the Storm." *The Economist*, June 28, 2007.
- Dornbusch, R., Y. C. Park and S. Claessens (2000). "Contagion: How it spreads and how it can be stopped." World Bank Research Observer, http://siteresources.worldbank.org/INTMACRO/Resources/ClasessensDornbuschPark.pdf, accessed October 2007.

"Capital Controls in Chile in the 1990s (A)" (HBS No. 705-031)

Case Synopsis

In 1991, Chile adopted a framework of capital controls focused on reducing the massive flows of foreign investment coming into the country. Because international interest rates remained low, capital inflows threatened the central bank's ability to manage the exchange rate within a crawling band that aimed to eventually lower the rate of inflation to international levels. Until the Asian financial crisis of 1997 and the Russian debt crisis of August 1998, Chile's economy had performed spectacularly under, or perhaps despite, these controls. But in the aftermath of those crises, the country's economy began to suffer through both trade and financial channels. Its current account deteriorated not only because Chile relied on Asia as a market for one-third of its exports, but also because the price of copper, its largest export product, plummeted as demand from Asia dwindled. Financial flows to Chile, as to emerging markets in general, fell dramatically as investors panicked. By the end of 1999, Chile had experienced Latin America's most severe "sudden stop" of external capital flows. Many private sector observers blamed the controls for unnecessarily adding to the strain and demanded that they be dismantled. But Chile's central bank continued to defend the controls, arguing that they had helped to insulate the country from worse contagion. Chile was thus forced to decide what to do about its system of capital controls in this new economic environment.

A follow-up case, "Capital Controls in Chile in the 1990s (B)" (HBS No. 705-032), discusses the "sudden stop" in external capital flows to Chile in the years after the Asian and Russian crises, and details the changes in Chile's capital controls framework and exchange rate system between mid-September 1998 and June 2003. The case also discusses the impact of the U.S. Free Trade Agreement that went into effect in 2004 on the scope of future capital controls in Chile.

The note "Capital Controls" (HBS No. 702-082), which traces the modern history of capital controls and presents the debate regarding the advantages and disadvantages of international financial market regulation, is a useful complement to the Chile cases.

Teaching Objectives

- Explore the relationships among capital mobility, exchange management, and monetary policy (the "irreconcilable trinity").
- Introduce the mechanics and objectives of capital controls.
- Highlight the academic discussion of, and encourage students to debate, the advantages and disadvantages of capital controls, particularly on inflows.
- Compare Chile's experiences with capital controls in the 1980s and 1990s, and discuss the importance of other policies (such as bank regulation and fiscal policy) to encouraging economic growth and deterring economic crises.

Proposed Assignment Questions

1. Why did Chile institute capital controls in 1991? Did the controls achieve their objectives? What roles did other policies play in Chile's economic success in the 1990s?

2. What were the arguments for and against dismantling the controls in the wake of the Asian and Russian financial crises? What were the alternative policy options? Was Chile in danger of suffering a crisis such as that of 1982?
3. How should the relaxing of controls be sequenced with other policies? What can other countries learn from Chile's experiences?

Supplementary Reading List

- Alfaro, L. and R. Abdelal (2003). "Capital and control: Lessons from Malaysia." *Challenge*, 46, 36–53.
- Edwards, S. (1999). "How effective are capital controls?" *Journal of Economic Perspectives*, 13, 65–84.
- Laurens, B. (2000). "Appendix I: Chile's Experience with Controls on Capital Inflows in the 1990s." In *Capital Controls: Country Experiences with Their Use and Liberalization*, A. Ariyoshi *et al.* (eds.), IMF Occasional Paper 190.
- Cowan, K. and J. D. Gregorio (2007). "International borrowing, capital controls and the exchange rate: Lessons from Chile." In *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices and Consequences*, S. Edwards (ed.), Chicago: University of Chicago Press.

"Malaysia: Capital and Control" (HBS No. 702-040)

Case Synopsis

On September 1, 1998 Malaysia imposed strict currency and capital controls, banning offshore trading of the Malaysian ringgit and restricting outflows of capital. The Malaysian capital controls sparked an enormous controversy in the world of international finance, and they remain at the center of debates among economists and policy makers. These debates include the following questions: Did the Malaysian capital controls successfully insulate the country's economy from the crisis? Did the capital controls promote an economic recovery that outpaced Malaysia's more orthodox neighbors, such as Korea? Does the Malaysian experience hold lessons for other developing countries facing financial crises? The case is designed to encourage students to engage each of these debates. Malaysia: Capital and Control was written for use in Business, Government, and the International Economy (BGIE), a required first-year course at Harvard Business School.

The note "Capital Controls" (HBS No. 702-082) is a useful complement to the case.

Teaching Objectives

- Explore the relationships among capital mobility, exchange management, and monetary policy (the "irreconcilable trinity").

- Deepen understanding of the mechanics and objectives of capital controls as well as the academic discussion of, and encourage students to debate, the advantages and disadvantages of capital controls, particularly on outflows.
- Debates the origins of the Malaysian capital controls.

Assignment Questions

1. What caused the financial crisis in Malaysia?
2. Why did the Malaysian government impose currency and capital controls? Were the controls necessary? Were they effective? What were the benefits and costs? What are the lessons of Malaysia's experiment with currency and capital controls?
3. Why did the international financial community react so negatively to the Malaysian currency and capital controls?
4. What have been the effects of the Malaysian government's attempts to achieve "national unity" between 1971 and 2001?

Supplementary Reading List

- Alfaro, L. and R. Abdelal (2003). "Capital and control: Lessons from Malaysia," *Challenge*, 46, 36–53.
- Jomo, K. S. (2001). "Capital controls." In *Malaysian Eclipse: Economic Crisis and Recovery*, K. S. Jomo (ed.), London: Zed.
- Kaplan, E. and D. Rodrik (1998). "Did the Malaysian Capital Controls Work?" NBER Working Paper No. 8142. Also see Krugman, P. "Saving Asia: It's time to get radical." *Fortune*, September 7, 74–80.
- Krugman, P. (1998). "An Open Letter to Prime Minister Mahathir." reprinted in *Fortune*, September 28, 35–36; Krugman, P. (1999). "Capital control freaks: How Malaysia got away with economic heresy." *Slate*, September 27.

"Brazil 2003: Inflation Targeting and Debt Dynamics" (HBS No. 704-028)

Case Synopsis

In October 2002, Brazilians elected for the first time in the country's history a left-wing president, Luís Inácio "Lula" da Silva. As markets faltered in response, da Silva reaffirmed his commitment to fiscal discipline, a floating exchange rate, and inflation targeting. By August 2003, however, his attempt to change market sentiment was coming under threat, as the country faced a looming recession. Skeptics began to worry that the new PT (Worker's Party) government would be forced to resort to printing money to meet its campaign promises. Moreover, with observers questioning the sustainability of Brazil's large public debt situation in the wake of Argentina's massive default on its public debt at the end of 2001, da Silva was